

Testimony before the Subcommittee on Aviation  
U.S. House of Representatives  
Committee on Transportation and Infrastructure

“The Financial Condition of the U.S. Airline Industry”

June 3, 2004

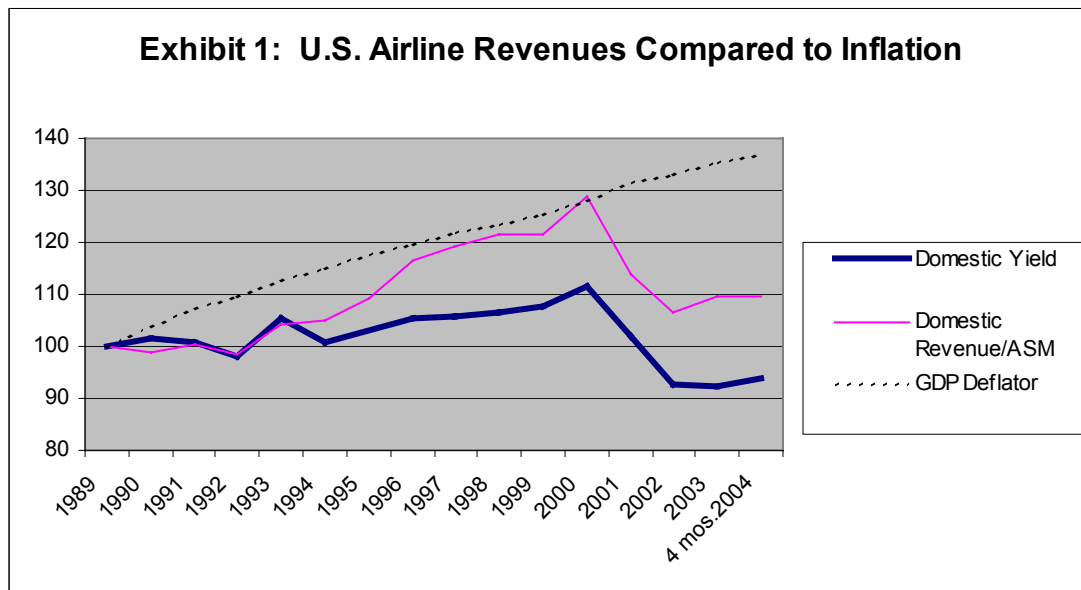
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Good morning, Mr. Chairman, members of the Subcommittee, ladies and gentlemen; thank you for the opportunity to testify today.

The U.S. airline industry is in the midst of a painful transformation, a process that has accelerated over the past several years due to the global aviation downturn. Following the events of September 11, 2001, the main causes of the industry's losses were clearly security concerns and an economic downturn. Since mid-2002, however, it has become increasingly obvious that longer-term, structural changes are driving the turmoil. More recently, high fuel prices have added to the misery. This morning, I hope to provide some perspective on the airline industry's problems by addressing two related topics:

1. What is causing the heavy losses reported by most large U.S. airlines?
2. What are the implications of these results for the airlines' long-term financial viability?

First, why are most airlines reporting heavy losses in a strong economic environment? The two principal causes are continued weak revenues, compared to historical levels, and high fuel prices. The revenue problem is due mostly to increasingly competitive pricing in the domestic market. Exhibit 1 shows yield, the standard industry measure of pricing, and revenue per available seat mile, the measure of revenue generated per unit of capacity, as reported by the Air Transport Association, for the U.S. domestic market.

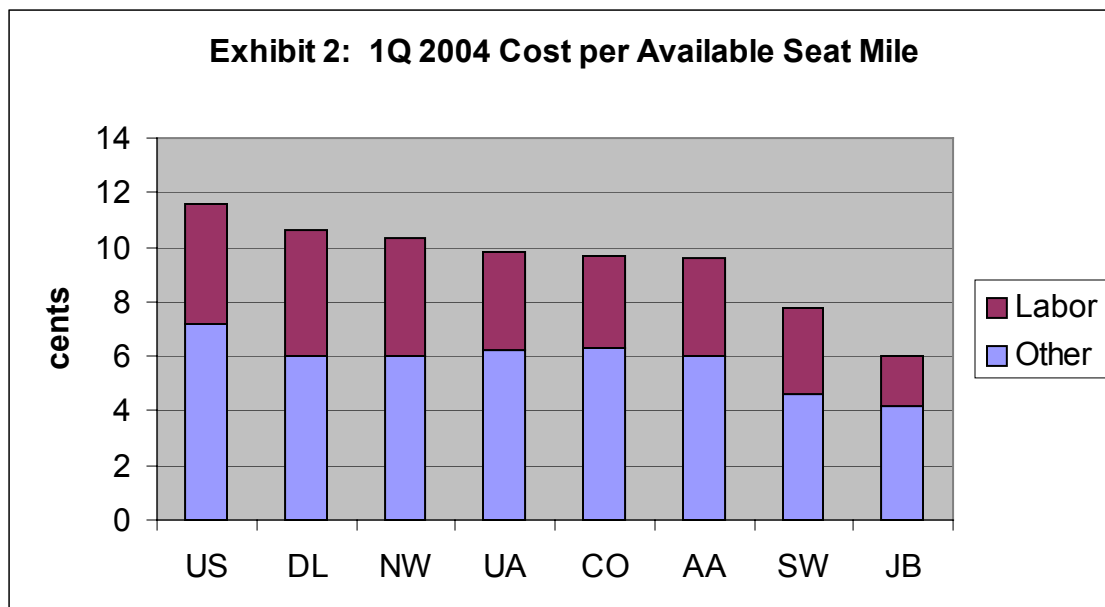


The data is expressed as an index, where the levels of 1989 are set equal to 100. As can be seen, these measures, particularly yield, turned sharply downward starting in 2001, and have recovered only modestly over the past year. The revenue per available seat mile

line is higher than that for yield, because the former takes into account also airlines' "load factor" (seat utilization), which has been rising. As any passenger who has flown recently can attest, the planes are very full, even if their operators are losing money. Shown also in this Exhibit is an index of inflation, measured by the gross domestic product (GDP) deflator, with 1989 set to equal 100. The gap between this line and the two airline measures shows how much worse the recent decline is when measured in real, rather than nominal, terms.

The driving force behind this situation, as is well known, is the rapid spread of low-cost competition and the effect that has had on pricing of tickets used by business passengers in the domestic market. Low-cost airlines have been gaining market share for several decades, but that growth accelerated during the past several years as the large "legacy carriers" like American Airlines and United Air Lines pulled back their service and concentrated on conserving cash. Although the legacy carriers are now fighting back more vigorously against their low-cost rivals, and the loss of market share is likely to slow, the spread of low fares in the domestic market will continue. The balance of power between the low-cost and legacy airlines has reached a tipping point, and the advantage now is clearly with the former.

With pricing changing inexorably, the legacy airlines are doing what any business would when faced with a more competitive environment--they are lowering their operating costs as best they can. However, their cost disadvantage against the low-cost carriers is immense. Exhibit 2 shows operating cost per available seat mile (measured in cents) for six legacy and two low-cost airlines in the first quarter of 2004.



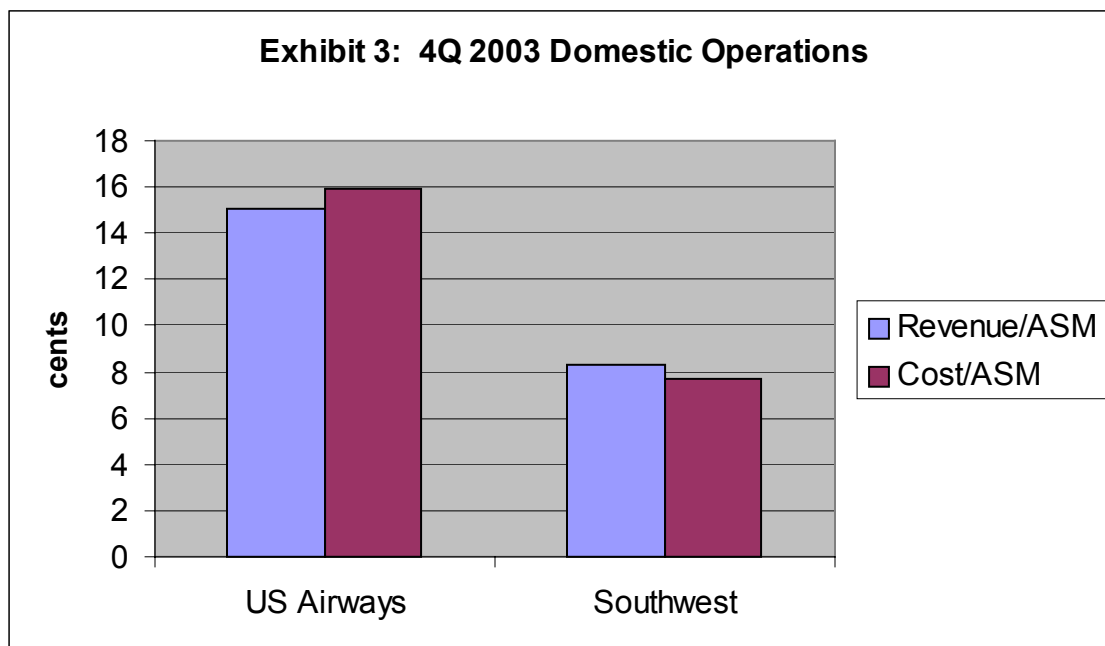
*Note to Exhibit 2 and following Exhibits:*

AA: American Airlines  
 CO: Continental Airlines  
 DL: Delta Air Lines  
 JB: JetBlue Airways

NW: Northwest Airlines  
 SW: Southwest Airlines  
 UA: United Air Lines  
 US: US Airways

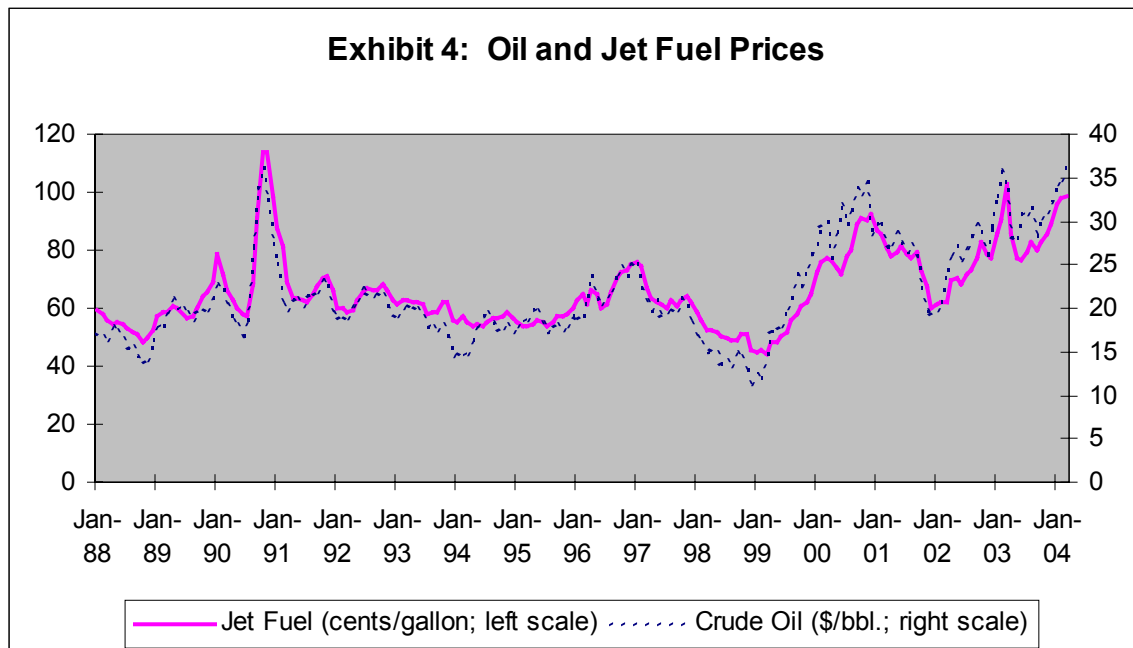
The costs are broken out between labor cost and other operating costs. Although the two low-cost airlines, Southwest Airlines and JetBlue Airways, each have an advantage versus their high-cost counterparts in both categories, the extent of the difference varies. Southwest, which pays its employees at or above industry averages, is able to incur lower labor costs because of more flexible work rules and better productivity. Those flexible work rules and the airline's distinctive business model allow it to use its assets more efficiently and report low non-labor operating costs, as well. JetBlue, in contrast, has a young workforce and lower average compensation than either the legacy carriers or Southwest. Some of the legacy carriers listed in Exhibit 2 have already gained significant concessions from their employees, lowering pay and making other changes. The still-significant gap labor cost differential against their low-cost rivals is due to a combination of a more senior (and thus higher-paid) work force, a continuing (if narrower) disadvantage in work rules, and a continuing large difference in pensions and benefits.

The legacy carriers still have a revenue advantage over the low-cost airlines, but it is narrowing. Exhibit 3 shows cost per available seat mile and revenue per available seat mile for US Airways and Southwest.



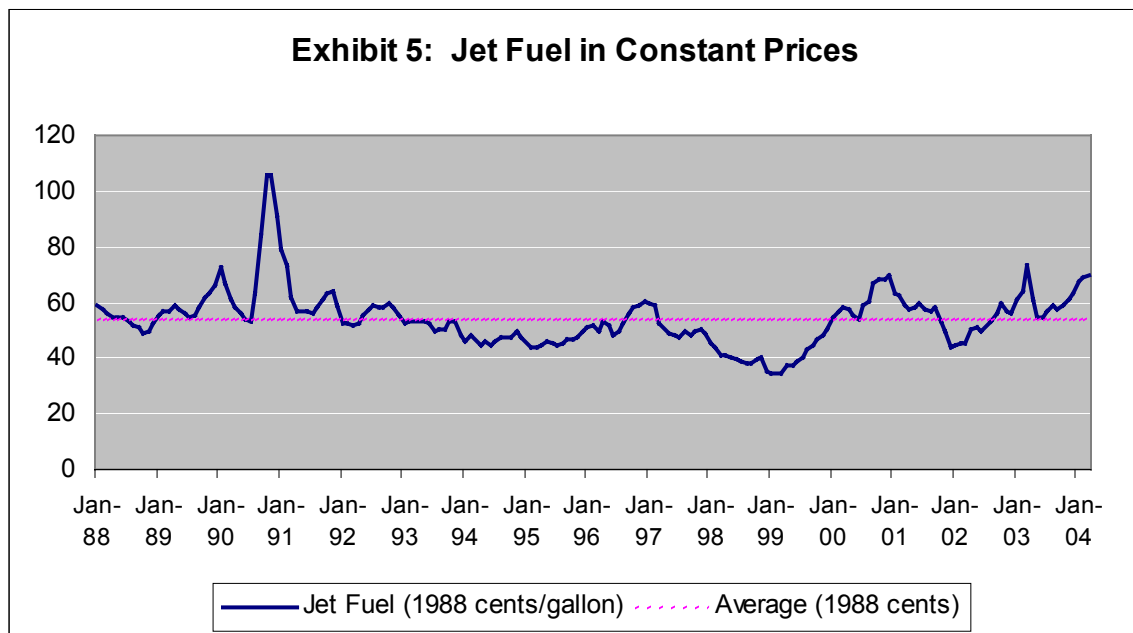
The figures are for domestic operations only, the battleground between these two airlines, and refer to the fourth quarter of 2003, the last period for which separate domestic data is available. As can be seen, US Airways has much higher revenues per available seat mile. Unfortunately, its costs disadvantage is even wider. The revenue difference will narrow over time, but US Airways—and other legacy carriers—should be able to maintain some modest revenue premium over most low-cost airlines. The hub-and-spoke business model is more costly to operate, but it also generates higher revenues. Indeed, several of the low-cost airlines—AirTran Airways, Frontier Airlines, and America West Airlines—choose to operate hub-and-spoke route systems. Even if the legacy carriers like US Airways have to absolutely match their low-cost rivals’ pricing on directly competing airport-to-airport segments, they can still generate somewhat higher revenues from passengers connecting off of regional partners, those connecting to international flights, and those attracted by frequent flyer programs and first class cabins. Note also that the extent of the revenue premium will vary depending on whether the legacy carriers is competing against a “no-frills” airline like Southwest or an airline offering more service amenities, like JetBlue or AirTran. The challenge for the legacy carriers is to bring their cost disadvantage more into line with their shrinking revenue advantage.

The second major factor driving the current heavy losses reported by most U.S. airlines is high fuel prices. The problem is not only that prices are high—they have been this high before—but that the outlook is for an extended period of high prices, not just a temporary spike. Exhibit 4 shows crude oil and jet fuel prices since 1988 through the first quarter of 2004.



As can be seen, periods when oil prices were above \$30/barrel have previously been fairly brief. This data, like the pricing data in Exhibit 1, should be considered within the

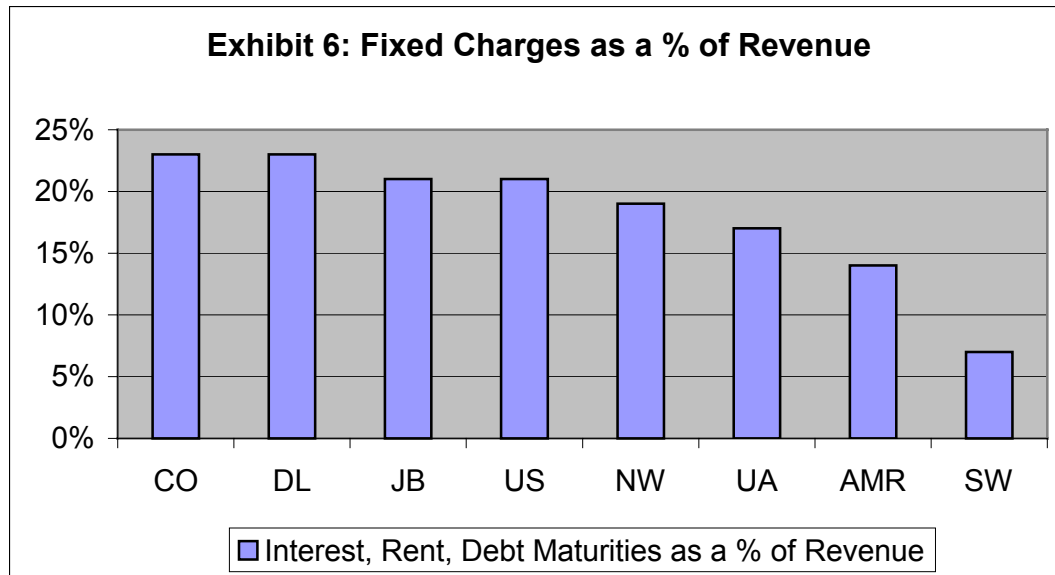
context of inflation, however. Exhibit 5 takes that jet fuel price data and recalculates it to 1988 prices, using the GDP deflator to measure inflation.



By this measure, current prices are high, but by no means near the levels reached during the first Persian Gulf War. The straight line across the chart shows the average price, measured in 1988 prices, throughout this entire period. If you compare Exhibit 4 to Exhibit 1, it becomes clear that much of the problem faced by airlines is that real fuel prices are modestly higher than the averages of the last fifteen years, but that the airlines' inflation-adjusted fares are lower. An examination of trends in labor costs, which form a far larger portion of airlines' total costs than fuel, would show the same contrast.

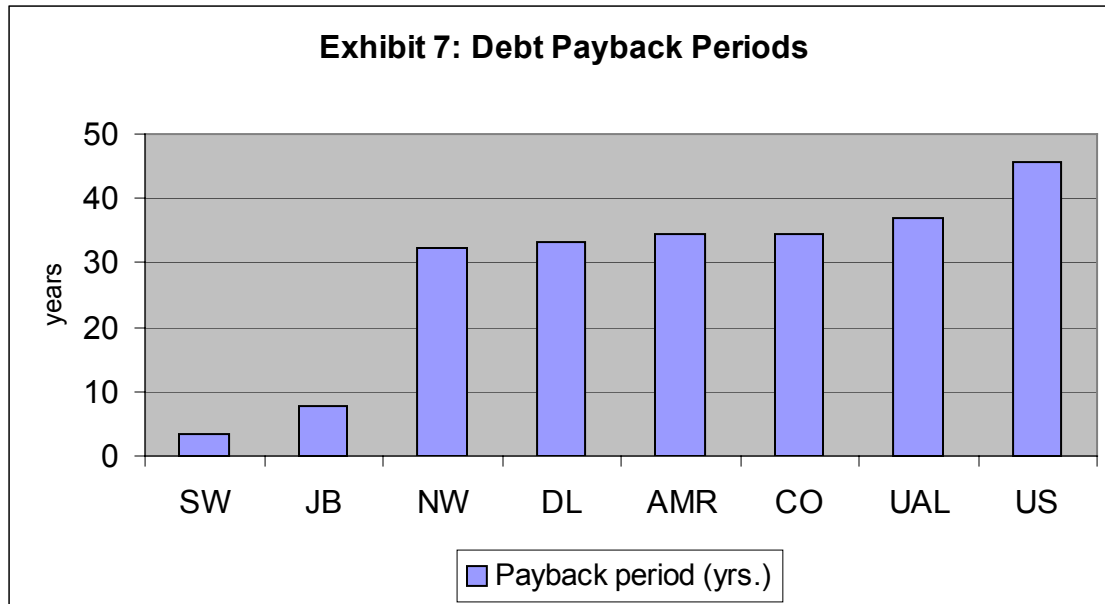
Fuel prices are an external factor that airlines cannot control. What can they do to react and minimize the damage? A comparison with other modes of transportation is revealing. Fuel represents a roughly comparable proportion of expenses for railroads and many trucking companies (in the mid-teens percent range), but they have not been hurt by higher fuel prices to nearly the same degree. Part of the difference is due to more active hedging programs by these freight transportation companies, but most is due to the fact that many of their contracts with corporate customers allow them to pass through higher fuel costs in the form of surcharges. Airlines have tried repeatedly to raise fares in response to high fuel costs, but with little success. Again, the problem comes back to a lack of pricing power in a very competitive market.

The second topic I would like to address this morning is the implications of these ongoing losses for the airlines' long-term financial viability. Airlines, already highly leveraged, have had to borrow heavily during the past several years in order to maintain adequate liquidity. The estimated fixed financial charges faced this year by airlines are shown in Exhibit 6, expressed as a percentage of revenues.



These claims include interest, rentals, and scheduled debt maturities. For most airlines, the total is higher than their fuel costs, representing 15% to 20% of revenues. Two airlines in the midst of difficult labor negotiations—Delta and Northwest—face substantial debt maturities in 2004 and 2005, underlining the urgency of securing concessions from their employees. Minimum pension funding requirements have not been disclosed by all airlines and are not included in the chart, but the recent pension reform legislation has eased that burden over the near term.

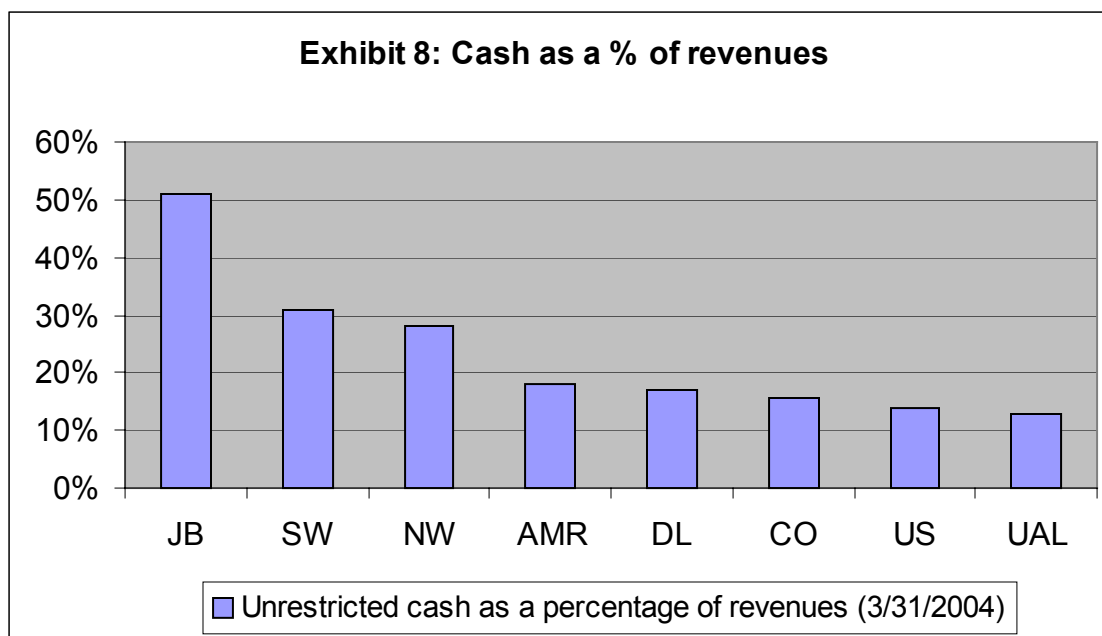
If we consider the airlines' indebtedness from a longer perspective, the picture is even more depressing. One of the credit ratios that Standard & Poor's focuses on is funds from operations as a percentage of total debt (including off-balance-sheet leases). The inverse of this ratio—total debt divided by funds from operations—is equivalent to a debt payback period. It answers the question, how long would it take to pay off all of a company's debt, if it devoted its internal resources solely to that task, with none left over for capital expenditures, dividends, or other uses. Exhibit 7 shows this calculation, based on the funds generated from operations for the twelve months ended March 31, 2004.



Southwest is in good shape: it could pay off its debt in a little over three years. JetBlue would take longer: almost eight years. However, the legacy carriers are in a much deeper hole. Each of them would take more than 30 years to pay off its debt and leases at the current rate of cash generation. In fact, almost all of their debt comes due before that, and the airlines' aircraft would be too old to fly by the time that payback period ended. The debt burden is so heavy for these airlines that they have little prospect of reducing it materially by issuing stock. Even bankruptcy can help only to a degree: US Airways went through bankruptcy but still has a fairly heavy fixed financial burden, and United's proposed reorganization would reduce their debt and leases by about one quarter. The only hope is to substantially improve internal cash flow, which means restoring earnings.

This borrowing, and several rounds of aid from the federal government, has at least bolstered the airlines' cash positions. Unrestricted cash as a percentage of revenues is shown in Exhibit 8.





The two large low-cost airlines, JetBlue and Southwest, have much healthier liquidity than the legacy carriers, though all of the airlines shown are carrying more cash than they have historically as a precaution against further threats to their solvency. Even so, with internal cash flow minimal or even negative and heavy upcoming debt and lease obligations, most legacy airlines' cash holdings are expected to erode over the coming year. This has already started to happen for Delta, US Airways, and United, and Continental has warned that it, too, faces pressures on its liquidity.

Standard & Poor's ratings on U.S. airlines reflect these difficult prospects. Exhibit 9 shows broad rating categories, ranging from 'AAA', the highest possible rating, to 'D', for default, and which airlines' corporate credit ratings fall into these categories currently.

**Exhibit 9: S&P Airline Ratings**

AAA	
AA	
A	SW
BBB	
BB	JB, ALK
B	NW, CO, AAI, AMR, AWA, DL, ACA
CCC	ATA, US
D	UAL

The finer gradations of pluses and minuses are not shown, but the airlines are ordered by rating strength within each category. Southwest's rating is solidly investment grade, but all the others are well into the speculative grade rating categories (BB through D). We

also assign outlooks to our ratings, and many of these, particularly for ratings of the legacy airlines, are negative, meaning the ratings may fall further still.

Given this difficult financial outlook, a range of outcomes is possible over the longer term. The more optimistic, but still plausible, scenario is that most or all of the legacy airlines will scrape by, cutting costs and benefiting from rising traffic. They will continue to lose market share to low-cost airlines, but will lower their costs enough to survive. In time, some may merge, reducing their number to three or four. There could also be consolidation among low-cost airlines, particularly now that they have become so pervasive that they are increasingly competing against one another.

Even in this optimistic scenario, though, the legacy airlines will remain relatively fragile financially. It will be almost impossible for them to restore their financial strength as they did during the 1990s, following the previous industry downturn. I do not foresee any of them returning to investment grade ratings, though they could be upgraded modestly. This has implications for what may happen in the next industry downturn. Large airlines have historically exhibited considerable staying power, in spite of frequent losses. Eastern Air Lines, Trans World Airlines, and Pan American World Airways lasted for years before entering bankruptcy and then lingered further inside Chapter 11. The reason is that airlines, particularly the legacy carriers, have assets—aircraft, leases on airport facilities, and route rights—that have potential value to other users, and therefore can be used as collateral for loans or sold for cash. However, during the last several years, all of the large airlines have gradually encumbered almost all of their assets and thus have little or nothing to borrow against. In addition, the capital markets are looking more skeptically at aircraft as collateral, requiring more conservative collateral coverage or refusing to lend at all.

This lack of backup financial resources and the breadth of the financial weakness across the industry mean that a wave of bankruptcies is possible in the next aviation downturn. There have been multiple airline bankruptcies in the past, but in those cases there were surviving airlines that were relatively healthy. Now, none of the legacy airlines, which still account for almost three quarters of total traffic carried, can be described as “healthy.” Never before have virtually all U.S. airlines had such low ratings.

In an industry that faces the threat of terrorism, “the next industry downturn” could happen tomorrow. That forms the basis for the pessimistic scenario. If a renewed industry crisis occurs, airlines’ cash reserves would shrink rapidly and the wave of bankruptcies mentioned above could occur over the next year. Such a scenario would probably cause some of the weaker carriers to cease operations and liquidate. The disappearance of an airline the size of US Airways would benefit the surviving legacy carriers somewhat, but many of its markets would likely be captured by low-cost airlines, which have planes on order and could redirect them to the newly available opportunities. The shutdown of an airline the size of United would provide more substantial and lasting benefits to the legacy carriers, both because United is much larger and because its valuable international routes would be acquired by other legacy airlines. Such an outcome would help the industry’s balance of supply and demand and improve the

survivors' operating results, but not change the airlines' fundamental need to lower operating costs. As with US Airways, some of United's domestic markets would be taken over by low-cost carriers, whose market share, and pricing influence, would grow further.

To conclude, let me summarize my answers to the questions posed at the beginning of my testimony. First, the heavy losses reported by most large U.S. airlines, despite healthy economic conditions, are due mainly to low-cost competition in the domestic market and to high fuel prices. The former is a permanent, structural change; the latter is harder to predict but may persist for the foreseeable future. Second, the financial condition of most large airlines is best described as fragile, with limited ability to withstand external shocks to their revenues or expenses. Although the legacy airlines may be able to restore profitability, they will remain heavily indebted and therefore financially vulnerable in the next industry downturn.

Thank you for your attention.